ANALYSIS OF TAX PROPOSALS AND TAX RELATED PROPOSALS IN H.R. 833 BEFORE THE SUBCOMMITTEE ON COMMERCIAL & ADMINISTRATIVE LAW HOUSE COMMITTEE ON THE JUDICIARY MARCH 18, 1999

Remarks by:
Jack F. Williams
Professor
Georgia State University
College of Law
140 Decatur Street
Atlanta, Georgia 30303
404.651.2139
jwilliams@gsu.edu

Mr. Chairman and members of the Subcommittee, my name is Jack F. Williams. I am a Professor of Law at Georgia State University College of Law in Atlanta, Georgia. In 1999-2000, I will serve as a Visiting Professor of Law at St. Johns University School of Law in New York City, where I will aid in the implementation of the first LL.M. program in Bankruptcy in the United States.

I have a keen interest in the interplay between the Bankruptcy Code and the Internal Revenue Code, having written numerous articles and a two-volume treatise on the subject. I was also honored to serve as the Tax Adviser to the National Bankruptcy Review Commission ("NBRC") and as the Chair of the NBRC's Tax Advisory Committee. Additionally, I have frequently taught courses on Bankruptcy and Insolvency Taxation and Advanced Bankruptcy Tax Collection to Internal Revenue Service personnel and State and Local taxing authorities under the auspices of the New York University/Internal Revenue Service Continuing Education Program. I am also presently serving as Vice-Chair of the American Bankruptcy Institute Bankruptcy Taxation Committee. The views expressed are my own and not necessarily those of the institutions identified above.

In preparing these brief remarks, I have considered the tax proposals in HR 833. Specifically, I have considered Sections 603-604, 801-818, and have included a few remarks about the means-testing proposal based upon my research and observations on how federal taxes are collected. I divide my comments into three categories:

1. Comments on what should be added to HR 833

2. Comments on the tax provisions in HR 833

3. Comments on the use of the IRS Collection Standards in the Means-testing proposal in HR 833.

Before I begin my specific remarks, however, I point out that most of the proposals in HR 833 were recommendations by the NBRC. Nonetheless, as others have noted, several of the proposals contradict both the NBRC recommendations and the opinion of the NBRC's Tax Advisory Committee. I find that I am in general agreement with most of the tax proposals made in HR 833, subject to some minor to moderate tinkering with the proposed statutory language. However, it is my opinion that the tax proposals in HR 833 are too one-sided; they portray just one side of the difficulties confronted in the bankruptcy tax arena. It was my intention as the Chair of the Tax Advisory Committee to the NBRC to ensure that a complete, unfettered airing of the issues took place among the members of the Advisory Committee. The purpose of the discussions was to move toward some consensus on a broad array of bankruptcy taxation issues. I was and continue to be extremely proud of those who served with me on the Advisory Committee and of their efforts to reach consensus on a package of highly controversial tax matters. Our goal was to present a comprehensive package of reform in the bankruptcy taxation area. Instead, what HR 833 includes are the provisions that tend to favor the taxing authorities while ignoring those proposals that would have resolved recurring problems in the actual practice of bankruptcy taxation or provided relief to debtor/taxpayers. Thus, what is HR 833 does not include our the recommendations in the Tax Advisory Committee Report that tend to balance the competing interests of other creditors (that is, those creditors other than the taxing authorities) and the debtor against the taxing authorities. I find this difficult to understand, particularly at a time when the Congress has, rightfully I may add, reigned in the powers of the Internal Revenue Service in the assessment and collection of taxes outside of the bankruptcy process.

I. ADDITIONS TO HR 833

1. Conform State and Local Tax Issues to Federal Laws

One of the most significant discrepancies in present bankruptcy tax law is the significant differences in how federal taxes are treated on the one hand, and state and local taxes on the other. These discrepancies are confronted every day in countless bankruptcy cases at great time, expense, and confusion and to no one's benefit. HR 833 should contain a series of proposals to conform §346 of the Bankruptcy Code to the IRC. In particular §346 should be modified to mirror the IRC §1398(d)(2) election and conform state and local tax attributes that are transferred to the estate to those transferred for federal income tax purposes. (NBRC Proposals 4.2.4, 4.2.16-4.2.17).

2. Bifurcate Corporate Taxes that Straddle the Bankruptcy Petition Date

The NBRC recommended that corporations have the same right as individuals to elect to have taxes incurred prior to the filing for tax years that straddle the petition date to be considered a prepetition tax and tax incurred for the balance of the tax year after the petition is filed to be classified as an administrative expense. The Eighth and Ninth Circuits presently allow the debtor to bifurcate the taxes to achieve this result. Although the Tax Advisory Committee split on this issue, a proposal in HR 833 is necessary to resolve this issue.

3. Subordination of Prepetition Nonpecuniary Loss Tax Penalties

After having correctly observed that granting a priority to tax penalties unfairly harms the general unsecured creditors of the bankruptcy estate, the NBRC recommended that the payment of prepetition nonpecuniary tax penalties in chapters 11, 12 and 13 be subordinated to the payment of general unsecured claims. The argument against subordination is weak especially where creditors may not have the ability to monitor their debtor's compliance with tax reporting requirements.

4. Application of the Burden of Proof Rules to Tax Issues in Bankruptcy

The appropriate burden of proof for tax claims in the bankruptcy process is as yet unresolved. The Tax Advisory Committee recommended either following applicable nonbankruptcy law on the issue or allowing the shifting of the burden from the debtor to the taxing authority upon a proper showing. Either alternative is better than the present unsettled state of affairs.

II. TAX PROPOSALS IN HR 833

I am in general agreement with many of the proposals in HR 833. In particular, Proposals §603-604 contain much of the substance of the recommendations on the filing of tax returns in individual debtor cases that were recommended by the Tax Advisory Committee. Aside from a little minor tweaking with the language and greater protection against dissemination of confidential tax information, I would endorse these provisions. I am also in general agreement with Proposal 801 but would recommend the deletion of 801(b). My experience has shown that debtors in financial difficulty do not typically object to tax claims when the debtor has little financial incentive to do so, thus resulting in unreasonably high tax claims. I am in general agreement with 803, 804 (assuming that the interest rate is determined without reference to IRC §6621(c)), and the part of 805 that provides for the tolling of priority tax claim time periods during a pending bankruptcy case. However, I do not agree with that part of 805 that would extend the tolling provisions of the Bankruptcy Code to installment agreements. This is an unfair proposal and amounts to over-reaching on the part of the government. It will also have a drastic impact on the incentive for debtors to attempt to informally work out their tax liabilities with the taxing authorities. Finally, I am in general agreement with Proposals 808, 810, 811, 812, 813, 814 (with modifications to include returns filed under IRC 6020(b)), 815, 816 (with modifications to provide that a return under IRC §6020(b) or similar federal, state, or local law constitutes a filed return for dischargeability purposes under the Bankruptcy Code), 817, and 818.

III. MEANS TESTING

Under HR 833, §§101-102, a Chapter 7 case may be dismissed or converted to a Chapter 13 case if the case would involve "abuse" of Chapter 7, instead of the "substantial abuse" now required under §707(b). Abuse under §707(b) would be presumed if, during a 5-year period, the debtor would have sufficient income to pay at least $5000 ($83.33 per month) toward general unsecured claims or to repay at least 25% of those claims. The debtor's ability to pay general unsecured claims would be calculated by deducting three categories of expenses from the debtor's current monthly income—defined on the basis of the debtor's average monthly income for 180 days prior to filing—(1) expenses allowed under IRS collection standards; (2) payments on secured claims that would become due during the 5-year period, divided by 60; and (3) all of the debtor's priority debt, again divided by 60. It appears that the only way for a debtor to rebut the presumption of abuse would be to show "extraordinary circumstances that require additional expenses or adjustment of current monthly total income" through detailed itemizations and explanations sworn to by both the debtor and the debtor's attorney.

Based on my experience as a practitioner and commentator in the fields of both bankruptcy law and tax law, I find the use of the Internal Revenue Service collection standards in the means testing proposal problematic if not outright silly. First, it is my experience that the IRS itself often deviates from the collection standards in the informal negotiation of tax liability and collection matters in the field. IRS personnel are vested with sufficient discretion to permit latitude in reaching installment agreements and offers in compromise based on the individual facts and circumstances of each taxpayer. In fact, the Congress has sent this clear signal to the IRS over the past two terms, demanding more cooperation by the IRS with taxpayers in the negotiation of tax liabilities. My experience has shown that the collection standards are merely a common reference for starting negotiation and nothing more. Tying debtor eligibility to a formula that the IRS deviates from on a regular basis makes no sense.

Second, the collection standards are too parsimonious. One should carefully consider the specific items identified in the collection standards -- not just bandy the collection standards about in a general manner. After some thought, one must conclude that the standards are unrealistic. The IRS personnel know this fact and often deviate from the collection standards in an effort to promote settlement of tax claims.

Third, the collection standards may be at odds with the clarity and the uniformity that the Congress seeks in its means-testing proposal. For example, the IRS collection standards in calculating disposable income include a category entitled "other necessary expenses" that may or may not be congruous with the means testing proposal's "extraordinary circumstances" language. Additionally, the IRS collection standards do not specify any particular allowance for "other necessary expenses." Thus, trustees and courts will have to grapple with the issue on an ad hoc basis, lacking any clear guidance from the Congress. Finally, the folly of the IRS collection standards is experienced in full bloom where an expense arises from "extraordinary circumstances" under the means-testing proposal as opposed to the category of "other necessary expenses" contained in the IRS collection standards. If the expense is an "extraordinary expense" as opposed to a bona fide "other necessary expense" a debtor would be required to explain the expense under oath executed by both the debtor and the debtor's attorney. One

is hard-pressed to believe that trustees will employ a coherent approach across the country as to how to determine whether any given expense should be categorized. Yet, the results of that characterization will have significant impact on debtor eligibility.

IV. CONCLUDING REMARKS

In summary, the tax provisions in HR 833 are generally a good step in the right direction. Unfortunately, the proposals in HR 833 are out of balance. They fail to strike a careful and coherent balance among the many constituencies affected by bankruptcy tax proposals and miss outright some of the most difficult recurring problems in bankruptcy. Bankruptcy tax reform is too rare an opportunity to ignore all sides of these disputes. The taxing authorities' interests and concerns are forcefully put forth throughout the tax proposals. I agree with many of these proposals. However, the virtual lack of proposals seeking accommodation or reconciliation of competing constituencies in the bankruptcy tax process is detrimental to the overall structure and philosophy of bankruptcy taxation and is simply unfair. We can do better.

I thank you for the opportunity to share my thoughts on the tax proposals contained in HR 833. Please know that I shall be delighted to provide any additional information to the Committee and to the Congress in its commendable work on bankruptcy reform legislation.